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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 285

FIRST STATE BANK OF STRATFORD, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 21-32) are reported at 8 T. C. 831. The opinion of the Court of Appeals (R. 71-85) is reported at 168 F. 2d 1004.

JURISDICTION

The judgment of the Court of Appeals was entered on June 25, 1948. (R. 86.) The petition for a writ of certiorari was filed September 17, 1948. The jurisdiction of this Court rests upon 28 U. S. C. 1254.

QUESTION PRESENTED

After collections were begun and expected on notes on which petitioner had in prior years taken deductions for bad debts, petitioner declared a dividend of the notes. The question is whether $10,548.20 of the amount collected on the notes in the remaining two and a half months of the taxable year, representing the amount of the collections on which petitioner had received a tax benefit and which therefore would have been income to petitioner had it retained the notes, is taxable to petitioner as anticipatorily assigned income.

STATUTE INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income * * *, of whatever kind and in whatever form paid, * * * derived from any source whatever. * * * [26 U. S. C. 22]

STATEMENT

The facts as found by the Tax Court are as follows:

Petitioner is a corporation, organized under the law of Texas, and engaged in the business of banking at Stratford, Texas. It has outstanding 500 shares of stock. On October 17, 1942, the bank had 9 stockholders, of whom 5 were directors. Three of the directors worked in the bank. (R. 22.)

On October 17, 1942, at a regular monthly meet-

ing of the board of directors, all directors (L. M. Price, A. E. Pronger, P. J. Pronger, U. N. Price, and Hose Flores) being present, a dividend in kind was declared, consisting of notes which had been charged off as worthless and deducted as bad debts in income tax returns in earlier years. These notes had been charged out of assets and did not appear on the bank's books. They had been kept in a case by themselves. They were brought to the directors' meeting and the possibility of their collection discussed. About $25,000 had previously been collected on the notes included in the dividend, and on some of the notes included in the dividend payments were then being currently made. (R. 22-23.) The minutes of the action taken by the directors read (R. 23-24):

> The following recoveries were read and discussed by the directors:
>
> | | |
> |---|---|
> | Troy Plunk ..... | $5.00 |
> | E. O. Palmer ..... | 15.00 |
> | Arthur Cartrite..... | 1,200.00 |
> | Dortha S. Daniels..... | 4.00 |
> | J. L. Turner ..... | 8.00 |
> | Dortha S. Daniels..... | 4.00 |
>
> The payment of a dividend by the bank was next considered. Attention was called, however, to the matter of increased income and excess profits taxes and the advisability of deferring the payment of a cash dividend until later in the year when more would be known about the new Income Tax Law about to be

enacted in Congress. It was pointed out that the bank had a number of charged off accounts of doubtful value, also real estate carried on the books at a nominal sum of $1.00. Advisability of paying a dividend of a portion or all of these properties was discussed and fully considered. Upon motion duly made and seconded, the following resolution was adopted:

Whereas, This bank is the owner of several thousand dollars of charged off notes, some of which may be collected in future, and the balance of which are of doubtful value.

Now, Therefore, Be it resolved that the following charged off notes be assigned to the stockholders of this bank without recourse on it, said notes being paid as a dividend in kind and without any value being placed thereon by this bank.

Then follows a listing of the notes included in the dividend. No valuation was placed on the notes by the resolution. The bank's officers hoped that the majority of the notes would be collected, but their value was difficult to determine. Notes of about $160,000 to $170,000 (the amounts unpaid thereon) were examined as to collectibility, of which about $57,000 were considered notes with remote chance of collection, and the notes were listed in the dividend resolution with an amount set opposite each, totaling $111,254.38, as to all. These included the following notes (R. 24):

Troy Plunk	$32.29
E. O. Palmer	1,101.54

Arthur Cartrite	4,664.35
Dorothy S. Daniels	82.00
J. L. Turner	676.56
H. B. Ritchie	75.00
H. B. Ritchie	5,103.07

Notes considered completely uncollectible were not included in the dividend. (R. 24.)

After the directors' meeting, the directors, as stockholders, further discussed the matter. L. M. Price suggested, with the approval of P. J. Pronger, that W. N. Price take charge for the stockholders of the notes which had been included in the dividend. The matter was discussed and the notes included in the dividend were endorsed, within the next few days, to W. N. Price, as follows: "Pay to the order of W. N. Price, Special, without recourse, First State Bank of Stratford, by Hose Flores, Assistant Cashier." Amounts thereafter collected in 1942 on the dividend notes were deposited in the bank in an account designated, "W. N. Price, Special." W. N. Price, in attempting collection of the dividend notes, did nothing special that he did not do in collecting notes owed to the bank. At various times he worked after banking hours collecting the dividend notes. No system of bookkeeping for the dividend notes was set up by the stockholders in 1942. (R. 24-25.)

On November 15, 1942, the board of directors held a meeting, at which they discussed recoveries as follows: J. L. Turner, $8; H. B. Ritchey, $40;

and a loss on H. B. Ritchey loan, $75. H. B. Ritchey had two notes, one of $75 and one of $5,103.07; J. L. Turner, one of $676.56. The $40 collection from H. B. Ritchey and $8 from J. L. Turner were deposited in the W. N. Price special account on December 19, 1942. (R. 25.)

From October 17, 1942, to December 31, 1942, collections of $11,662.71 were made on the dividend notes. The record does not indicate what part is interest, or principal. No report as to collections on the dividend notes was made to the directors by W. N. Price. On several occasions he reported the amounts collected to the stockholders, by telephone or personally. The debtors were not notified of the assignment of their debts to the stockholders. The notes when paid were stamped "Paid" with a stamp on which appeared the bank's name, but not the stockholders' committee. The stockholders could withdraw such collections from the W. N. Price special account; they were not available to the bank. Between 60 and 70 per cent of the dividend notes have been collected. (R. 25.)

The first distribution to stockholders of money collected was in November 1943. This was decided on by the stockholders who were directors, not by all of the stockholders. There was no particular reason for delay. The stockholders did not particularly need the money. They did not demand the money in 1942. W. N. Price did not report any of the collections for taxation in 1942. (R. 25-26.)

The Commissioner determined that $10,548.20 of the $11,662.71 collected on the notes in 1942 was taxable income to the bank. (R. 26.) The Tax Court, with five judges dissenting, held that the recoveries on the notes were not income to the bank. (R. 26-32.) Sitting *en banc*, the Court of Appeals reversed the decision of the Tax Court, two judges dissenting. (R. 71-85.)

ARGUMENT

The reasons advanced by petitioner for further review of the case by this Court consist of assertions that the decision below is in conflict in principle with certain decisions of this Court and of the Courts of Appeals. Pet. 5-7.) Actually, the asserted conflict is not only non-existent but the decision below is supported by decisions of this Court.

The alleged conflict with *General Utilities Co.* v. *Helvering*, 296 U. S. 200, is premised upon two unwarranted assumptions—(1) that the *General Utilities* decision stands for the broad proposition that a corporation does not realize income by the declaration of a dividend in kind of anything that may be termed "property" (See Pet. 5; Br. 11-12, 15-16), and (2) that the court below held that a corporation does reali e income by the distribution as a dividend in kind of any type of property having a zero basis (See Pet. 5-6; Br. 13, 15). In the *General Utilities* case the Court simply held that the taxpayer-corporation did not realize taxable gain in the amount of the appreciation in value of

stock of another corporation distributed as a dividend in kind, there being no sale or use of the stock to discharge indebtedness. In the present case the court below held the *General Utilities* decision inapplicable because of the difference in the nature of the property involved in the two cases. It is plainly evident from the opinion that the result reached was directly attributable to the indisputable fact that, since the notes represented income to petitioner, the dividend assignment of the notes was merely an assignment of petitioner's right to collect income.[1] The *General Utilities* decision was distinguished on the ground that the stock there involved was a capital asset, meaning that "the fruit was on the tree", whereas the notes in the instant case represented *income* in that "the tree itself represents fruit of prior years that was not taxed."[2] (R. 80.) Thus, petitioner is in

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[1] As contrasted with stock or any other property as to which the potential income is represented by an appreciation in value, the realization of income by petitioner from these notes was not dependent upon a sale or other disposition. The bank would have realized income in the amount of the collections on the notes involved here had it retained the notes, for to that extent the notes represented previously charged-off debts on which petitioner had received a tax benefit. It is well settled, and petitioner does not dispute the fact, that, as the court below stated (R. 75), when a deduction for income tax purposes is taken and allowed for debts deemed worthless, recoveries on the debts in a later year constitute taxable income for that year to the extent that a tax benefit was received from the deduction taken in a prior year.

[2] There is no necessary relevance or merit in petitioner's statements (Br. 13) regarding the statutory definition of capital assets under Section 117(a)(1) of the Internal Revenue Code (26 U.S.C. 117). Under that section "capital assets"

error in stating (Br. 15) that the rationale of the decision below would make the effect of any dividend in kind depend upon the basis of the property distributed and that the decision would apply whether the basis of property had been reduced by depletion, depreciation, amortization, worthlessness, or any other charge against capital account. Since the decision below is limited in its applicability to property which itself represents income in that no sale or other disposition is necessary to the realization of income from it, the decision is not

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mean "property" with the exception of certain classes not involved here. The court below held that the dividend notes were "property", for it stated (R. 78) that the notes were assets of the bank and "subject to transfer as other property," but the fact that the notes were property does not mean that they were capital assets. The sense in which the court below used the term "capital assets" would seem to be a proper one (see definition of "capital", Webster's New International Dictionary (2d ed., 1939), p. 397) but in any event petitioner is not aided by its reliance upon Section 117(a)(1). In the first place, Section 117 merely operates to reduce the amount of gain taxed and loss allowed on the sale or exchange of types of property not excluded from the definition of capital assets, and, since no sale or exchange was involved here, the section is not controlling. Secondly, the fact that these notes were "property" and would come within the literal language of Section 117(a)(1) does not *per se* make them capital assets under that section, for even on a sale or exchange of property which merely represents the right to receive income such property is not considered a capital asset; instead, effect is given, as under the anticipatory assignment of income rule, to what the property represents, not the fact that it is property, and the sale price is considered a commuted substitute for the income the vendor would otherwise have received from the property. See *Hort* v. *Commissioner*, 313 U.S. 28; *Rhodes' Estate* v. *Commissioner*, 131 F. 2d 50 (C.C.A. 6th); *Helvering* v. *Smith*, 90 F. 2d 590, 592 (C.C.A. 2d). This also answers petitioner's statement (Br. 13) that "Under the statutory definition, the notes here were capital assets to the same extent as the stock in the *General Utilities case.*"

applicable, for example, to property subject to depreciation, from which no income could be realized in the absence of a sale or other disposition regardless of its basis.

When the decision below is viewed in the light of what it holds rather than according to petitioner's interpretation of it, the decision is not in conflict with this Court's decision in the *General Utilities* case. That decision not only did not purport to hold that income cannot be realized by a dividend assignment of the type of property involved here but this Court has held time and again that a person vested with the right to receive income does not escape the tax on it by any kind of anticipatory arrangement whereby the income is paid to another. *Helvering* v. *Horst,* 311 U. S. 112; *Helvering* v. *Eubank,* 311 U. S. 122; *Harrison* v. *Schaffner,* 312 U. S. 579; *Douglas* v. *Willcuts,* 296 U. S. 1; *Burnet* v. *Leininger,* 285 U. S. 136; *Lucas* v. *Earl,* 281 U. S. 111; *Commissioner* v. *Tower,* 327 U. S. 280; *Commissioner* v. *Harmon,* 323 U. S. 44; *Commissioner* v. *Sunnen,* 333 U. S. 591. Moreover, this rule was applied in *United States* v. *Joliet & Chicago R. Co.,* 315 U. S. 44, to a dividend arrangement. All of these cases involved an assignment of at least a right to receive income, which may be regarded as "property", and the *Horst* case, in which the anticipatory assignment of income rule was explained at length, involved the assignment of an interest coupon. These decisions require that

effect be given to what the property represents, not the fact that it is property, and it is the recognition of that very requirement on which the decision below is based.

Petitioner's assertions (Pet. 5; Br. 14-16) that the decision below conflicts in principle with *United States* v. *Cummins Distilleries Corp.*, 166 F. 2d 17 (C. C. A. 6th), and *National Bank of Commerce* v. *Commissioner*, 115 F. 2d 875 (C. C. A. 9th), also result from petitioner's failure to apprehend the true basis of the decision below. *United States* v. *Cummins Distilleries Corp., supra*, involved a dividend distribution of whisky, which is of the same type of property *as the stock involved in the General Utilities* case and is not covered by the decision below. *National Bank of Commerce* v. *Commissioner, supra*, involved the transfer of charged-off notes in a reorganization. The case seems to be relied upon by petitioner for the fact that the notes there involved were considered property and capital assets to the *transferees*. (See Pet. 5; Br. 14.) That the decision is not in conflict with the decision below is evident from the fact that the court below relied upon the decision, which also stated that to the *transferors* the notes represented income, not capital. (R. 75.)

Nor is petitioner correct in asserting (Pet. 6-7; Br. 16-17) that the decision below conflicts with *Helvering* v. *Horst, supra*, and *Blair* v. *Commissioner*, 300 U.S. 5, by discarding the fundamental

distinction drawn in those cases between an assignment of all interests in property and of a mere right to income. That distinction was as to income which had not yet been earned and had not accrued at the time of the assignment, and the cases are applications of the Court's holding in *Lucas* v. *Earl,* 281 U.S. 111, that income, the "fruit", is attributable to the "tree" on which it grows. Thus, in the *Horst* case, where a father transferred an interest coupon to his son as a gift, it was held that the father was taxable on the interest subsequently received by the son because the father had retained the bond which produced the interest. In the *Blair* case, on the other hand, it was held that the gift was of the income-producing property, consisting of an interest in a trust, and, as the Court later stated in the *Horst* case (311 U.S. at 119), the subsequently earned trust income was regarded as no more the income of the donor than would be a crop raised on a farm after the farm had been given away. The question whether the "tree" or just income has been assigned is of no importance when the income has been earned prior to the assignment, for the income remains attributable to the owner of the "tree" at the time the income was earned. *Austin* v. *Commissioner,* 161 F. 2d 666 (C.C.A. 6th); *Anthony's Estate* v. *Commissioner,* 155 F. 2d 980 (C.C.A. 10th). Similarly, in the present case, where the notes themselves represented income prior to their assignment as a

dividend and the dividend assignment was of petitioner's right to receive that income, the distinction drawn as between the *Horst* and *Blair* cases with respect to the source of the income is inapplicable. See *Richards' Estate* v. *Commissioner,* 150 F. 2d 837 (C.C.A. 2d); *Doyle* v. *Commissioner,* 147 F. 2d 769 (C.C.A. 4th).

Petitioner's statement that the decision below transcends the doctrine of the *Horst* case in holding the anticipatory assignment of income doctrine applicable to a dividend assignment (Pet. 6-7; Br. 17) is answered by the fact that in *United States* v. *Joliet & Chicago R. Co., supra,* this Court applied the doctrine to a dividend arrangement.

CONCLUSION

The decision below is correct and involves no conflict of decisions. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.
THERON LAMAR CAUDLE,
Assistant Attorney General.
ELLIS N. SLACK,
LEE A. JACKSON,
MELVA M. GRANEY,
Special Assistants to the Attorney General.

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